Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain

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Abstract

This paper's primary objective is to identify the relative importance of various Islamic financial products, in theory and in practice, by examining the financing records of the Bank Islam Malaysia (Berhad) and the Bahrain Islamic Bank. Currently, seven available Islamic financing products are considered viable alternatives to interest-based conventional contracts: *mudarabah* (trust financing), *musharakah* (equity financing), *ijarah* (lease financing), *murabahah* (trade financing), *qard al-hassan* (welfare loan), *bay` bi al-thaman al-ajil* (deferred payment financing), and *istisna`* (progressive payments). Among these financial products, *mudarabah* and *musharakah* are the most distinct. Their unique characteristics (at least in theory) make Islamic banks and Islamic financing viable alternatives to the conventional interest-based financial system.

The question before us is to determine the extent of *mudarabah* and *musharakah* in Islamic financing in practice. The data are as follows: the average *mudarabah* is 5% of total financing, and the average *musharakah* is less than 3%. The combined average of *mudarabah* and *musharakah* for the two Islamic banks is less than 4% of the total finance and advances. The average *qard al-*

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hassan is about 4%, while *istisna`* does not yet exist in practice. *Murabahah* is the most popular and dominates all other modes of Islamic financing. The average use of *murabahah* is over 54%. When the *bay` bi al-thaman al-ajil* is added to the *murabahah*, the percentage of total financing is shown to be 82.68%. This paper also explores some possible reasons why these two Islamic banks appear to prefer *murabahah* to *mudarabah* and *musharakah*.

Introduction

Islamic banking and finance are emerging as viable alternatives to conventional interest-based banking and financing. According to the General Council for Islamic Banks and Financial Institutions, there are currently 275 institutions worldwide that follow Islamic banking and financing principles, collectively managing in excess of $200 billion. These institutions are spread throughout 53 countries, including Europe and the United States. Twenty institutions now offer a variety of Islamic financial services in the United States.

In most of these countries, Islamic banking institutions must compete with conventional interest-based banking institutions. Their successful operations, along with the increasing number of Muslims in Europe and North America, have attracted western attention toward Islamic banking and finance. As a result, an increasing number of western financial institutions now offer Islamic investment products to Muslim investors. In 1996, for example, Citi Islamic Investment Bank, a wholly owned subsidiary of Citi Corp., opened in Bahrain; Chase Manhattan has an Islamic "window" in Frankfurt, Germany; and several multinational corporations, among them IBM and General Motors, have raised funds through an American-based Islamic leasing fund at the United Bank of Kuwait.

Due to the growing interest in Islamic banking in the West, a closer look at the Islamic bank's operations and characteristic features is warranted. This is the primary focus of this study.

Islamic banking in Malaysia differs in several ways, and for various reasons, from Islamic banking in the Gulf and the rest of the world. A comparison of Islamic banking in Malaysia and Bahrain, therefore, is valuable for two reasons: First, Bahrain's Islamic banking system is representative of the best practices of Islamic banks in general, and second, Bahrain and Malaysia are currently vying for recognition as the capital or hub of Islamic banking worldwide.

Islamic banking, which became established in the 1970s, currently consists of a variety of financial instruments or products. These include *mudarabah* (trust financing), *musharakah* (equity financing), *ijarah* (lease financing), *murabahah* (trade financing), *qard al-hassan* (welfare loan), and *istisna`* (progressive payments). The relative significance of these products in the Islamic banking system has yet to be studied. An additional objective of this paper is to determine the extent to which these two Islamic banks currently utilize these products. This information will be important to all participants in the Islamic banking and financing systems.

Review of the Literature

The extent of past scholarly research on modern Islamic banking and financing include studies by Siddiqi,[1] Khan,[2] Mannan,[3] Iqbal and Mirakhor,[4] Ahmad,[5] Zineldin,[6] Saeed,[7] Al-Omar and Abdul-Haq,[8] and Kahf.[9] These authors discuss the institutional issues, including Arabic concepts and principles of finance that are subject to interpretation. El-Ashker,[10] Wilson,[11] and Kazarian[12] provide financial comparisons that are useful in understanding the Islamic financial system. Maniam, Baxely, and James[13] analyze the perception of Islamic financing in the United States and also discuss the problems of applying Islamic financing tools. Bacha[14] attributes the low growth of *mudarabah* financing by Islamic banks to the agency problem.

Although few empirical studies are available, Akkas[15] compares Islamic banking with conventional banking in Bangladesh, and Kazarian[16] compares it with conventional banking in Egypt. Samad[17] and Samad and Hassan[18] compare the Bank Islam Malaysia (Berhad)'s performance with various conventional Malaysian banks. De-Belder and Hassan,[19] as well as Hamwai and Aylward,[20] address some aspects of Islamic financing and its relative success. Samad[21] compares the performance of interest-free Islamic banks to that of interest-based conventional banks with respect to profitability, liquidity risk, and credit risk.

The paper finds no major differences with regard to liquidity risk and profitability. However, a significant difference was observed in credit performance. This study will contribute to the existing literature on Islamic banking by providing data on the extent to which the various modes of Islamic financing are actually being utilized.

Overview of Islamic Finance and Banking

Principles of Islamic Banking

Islamic economics and financial institutions are guided by the Shari`ah, the precepts of which are founded upon the Qur'an, the Sunnah (the practices and sayings of Prophet Muhammad [pbuh]), and *fiqh* (jurisprudence, the opinion of Muslim legal scholars). According to the Shari`ah, Islamic financial institutions and modes of financing are based strictly on the following principles:

- Transactions must be free of interest (*riba'*).
- Goods and services that are illegal (*haram*) from the Islamic point of view cannot be produced or consumed.
- Activities or transactions involving speculation (*gharar*) must be avoided.
- Zakat (the compulsory Islamic tax) must be paid.

Following is a discussion of these four principles, which make the Islamic banking and financing system unique.

INTEREST (*RIBA'*). Qur'an 2:185 explicitly prohibits *riba'* and permits trade, but does not state clearly whether it is to be understood as interest or as usury. This lack of clarity has led to controversy among Muslim scholars in the past. However, there seems to be a general consensus that *riba'* includes all forms of interest, that is, any amount charged over and above the principal.

The Islamic financial system bans interest in all transactions. Thus, the payment or receipt of interest, which is the cornerstone of modern conventional banking, is explicitly prohibited in Islamic banking. Financial instruments and products that deal with interest are also prohibited. In other words, the prohibition of paying or receiving interest is the nucleus of Islamic banking and its financial instruments.

However, it should be stated that an Islamic financial system does not simply mean the avoidance of interest. An Islamic financial system or institution is much more than that, for it "is supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, and the sanctity of contracts."[22] By banning interest, Islam seeks to establish a just and fair society (Qur'an 2:239).

The return of a predetermined amount of fixed income by the lender, irrespective of the outcome of the borrower's venture, is considered unjust.

Fairness and justice demand that the owner (supplier) of capital has the right to be rewarded, but that this reward must be commensurate with the degree of risk associated with the project for which funds are supplied. Hence, what is forbidden is the predetermined fixed charge in financing a loan, an investment, or a commodity exchange.

But there is more to the Islamic banking or financial system than just interest-free financing For example, one must consider such factors as *gharar*, *haram*, zakat, and *qard al-hassan*, all of which are explained below.

GHARAR. Islam prohibits all games of chance and gambling:

> They will ask about intoxicants and games of chance. Say: “In both there are great evil as well as some benefit for man, but the evil which they cause is greater than the benefit which they bring.” (Qur’an 2:219)

In Qur’an 5:90, games of chance and gambling are prohibited because they cause enmity and hatred and also involve consuming property (*bay` al-batil*), which is a kind of oppression.

The question is whether *gharar*, which involves uncertainty or speculation, is *halal* (permitted) in business. According to Ibn Taymiyyah, if the sale contains *gharar* and devours the property of others, it is equivalent to gambling and, as such, *haram* (forbidden). Pointing to the phrase *devours the property of others*, Kamili[23] opines that speculative risk-taking in commerce, which involves the investment of assets, skill, and labor, is not similar to gambling. In business, participants engage in transactions designed to maximize profit through trading, not through any dishonest appropriation of other people’s property. Similarly, according to El-Ashkar, speculation in business is not the result of turning over a card or throwing the dice, but rather is

> … the practice of (a) using available information to (b) anticipate future price movements of securities so that (c) [the] action of buying and selling securities may be taken with a view to (d) buying and selling securities in order to (e) realize capital gains and/or maximize the capitalized value of security-holdings.[24]

Islam allows risk-taking in business transactions, but prohibits gambling. Maniam, Bexley, and James comment:

> The main idea is that investors should spend their effort searching for projects that are sound, that adhere to the Shari`ah, and share in the success or failure of that project.[25]

Islamic Investment Ethics. Investing in production and consumption is guided by a strict Islamic ethical code. Muslims are not permitted to invest in any production, distribution, and consumption enterprises involving alcohol, tobacco, pork, pornography, gambling, illegal drugs, and other harmful products, even though these enterprises may be profitable. In addition, Islam does not permit Muslims to invest in activities that are considered harmful for the individual or society. Thus, the scope of investment opportunities by Islamic banks is somewhat restricted when compared with the scope of financing open to conventional banks.

Zakat. Zakat is a compulsory religious tax payable to the poor by those who have acquired a certain amount of wealth (*nisab*). Each Islamic bank must establish a zakat fund and pay this tax if the level of its earned profits reaches the level of *nisab*. Paying zakat does not exclude Islamic banks from paying any business-related income taxes. Thus, Islamic banks face a dual constraint: the payment of a religious tax (zakat) as well as a regular business income tax.

Products of Islamic Banks and Their Key Elements. The prohibition of interest has led Islamic banks to create various Islamic financial instruments as alternatives to conventional financing methods. Based on the nature of the contracts, these Islamic financial products may be classified into two broad categories: equity-type contracts and mark-up price (debt)-type contracts.

Equity-type contracts. Mudarabah (trust financing) and *musharakah* (partnership), based on the profit-and-loss sharing (PLS) principle, are the only two products that fall into equity-type contracts.[26] Under a *mudarabah* contract, the two parties – the supplier of capital (*rabb al-mal*) and the entrepreneur (trustee of the venture) – share the profits according to an agreed-upon PLS ratio. It may be 70:30 or 80:20, depending upon the agreement.

The first key element of a *mudarabah* contract is that the lender is not guaranteed a specific return. There also is no fixed annual payment. This is in direct contrast to conventional interest-based lending/financing, in which a loan is not contingent upon the profit or loss outcome of the enterprise and is normally secured by collateral. Thus, any losses must be borne by the debtor and not the lender.

The second key element concerns losses that may arise from the business venture. According to Maniam, Bexley, and James:

> The financier or investor is not liable for losses beyond the capital he has contributed, and the entrepreneur or trustee does not share in financial losses except for the loss of his time and efforts.[27]

According to the Shari`ah, the supplier of capital bears the financial loss, not the trustee (*mudarib*) who runs the business. The third key element is that a financier (i.e., the Islamic bank) has no control over how the entrepreneur or trustee manages the business venture.

A *musharakah* underaking is a partnership contract between two or more parties, each of which contributes investment capital. In a conventional sense, it is a joint business contract.

The first element of a *musharakah* contract is that both parties contribute capital investment and that profits are shared by a prearranged agreement, not necessarily in proportion to their invested capital. In case of loss, both parties share in proportion to their capital contribution. The second element is that both parties share and control how the investment is managed. Thus, the Islamic bank has the right to examine the enterprise's books and supervise its management. The third element is that liability is unlimited. "Therefore," write Maniam, Bexley, and James, "each partner is fully liable for the actions and commitments of the other in financial matters."[28]

Given the above factors, both *mudarabah* and *musharakah* have elements of equity financing. The Islamic bank, as a supplier of funds, undertakes joint ventures with individual customers. Such a relationship is prohibited in the conventional banking system.

Mark-up price (debt)-type contracts. The basic principle of mark-up contracts is that the bank finances the purchase of assets in exchange for a negotiated profit margin. Two of the five instruments in this category are widely used.

Murabahah (Cost-plus-profit margin). Murabahah (*bay` bi al-thaman al-ajil*) is a cost-plus-profit margin contract whereby the Islamic bank purchases an asset on behalf of an entrepreneur and resells it to him/her at a predetermined price. This latter price includes the cost of the asset plus a negotiated profit margin. Under this contract, payment is made to the bank in the future either in a lump sum or in installments.

The key characteristic of a *murabahah* contract is that ownership of the asset remains with the bank until all of the payments have been made. This is a popular substitute for interest-based conventional trade financing.[29] From an economic point of view, *murabahah* financing and interest-based trade financing appear quite similar, except in their contractual features.

Ijarah (Lease financing). Ijarah involves acquiring the financing needed to use a particular asset. In such a contract, the Islamic bank purchases an asset on behalf of the entrepreneur and allows him/her to use it for a fixed rental payment. In *ijarah bi tamlik* or *ijarah wa iqtina`* (lease financing toward eventual ownership) financing, the Islamic bank buys an asset and leases it to the entrepreneur, who eventually opts to buy it at a previously agreed-upon price. The key characteristic of *ijarah* is that ownership of the asset remains with the Islamic bank or is gradually transferred to the entrepreneur as the lease payments are made.

The Islamic bank has other financial products, such as *bay` bi al-thaman al-ajil* (deferred payment financing) and *istisna`* (progressive payment). These debt-like products fall into the category of a "cost-plus" contract. A key characteristic of these contracts is that ownership of the asset unambiguously remains with the bank until all of the payments have been made.

Qard al-hassan (Benevolence loan). *Qard al-hassan,* a unique product of the Islamic bank, is a zero-return loan (a negative investment). All Islamic banks are urged or required to make these benevolence loans to needy and poor people. There is no financial return on this loan, for the borrower is obligated to repay only the principal.

We will now discuss the relative importance of these instruments in practice by examining the financing records of two Islamic banks: one in Bahrain and the other in Malaysia. We examine how they use the funds as they provide financing to their customers.

Data and Methodology

We have selected two Islamic banks for study: the Islamic Bank of Bahrain and the Bank Islam Malaysia (Berhad). These two banks were selected for several reasons:

- Both Bahrain and Malaysia provide relatively open access to bank information.
- Both banks operate in well-developed financial markets and compete with conventional financial centers and offshore banks.[30]
- Both banks operate according to the Shari`ah and compete with conventional banks, some of which also offer Islamic financial instruments to their customers but are not bound by the Shari`ah.
- While the relative importance of the various Islamic financial products may well differ in banks operating in Iran and Sudan, where all busi-

nesses and banks must comply with the Shari`ah, the two Islamic banks examined here are considered more representative of banks that are competing with conventional banks throughout the rest of the Muslim world.

The data for the Islamic Bank of Bahrain and the Bank Islam Malaysia (Berhad) were obtained from their 2002 annual reports. We have simply calculated the relative percentages of the various modes of financing used by them.

The Uses of Funds

The asset side of the balance sheets of the Bank Islam Malaysia (Berhad) and the Bahrain Islamic Bank, as presented in table 1, demonstrates the importance of the various Islamic financing modes. As we can see, total Islamic financing and advances by the Bank Islam Malaysia (Berhad) is only 50.65% of the total assets. On the other hand, the total Islamic financing by the Bahrain Islamic Bank is 78.57%. On average, the total Islamic financing for the two Islamic banks was 64.61% of assets.

Table 1. Allocation of Funds under Finance and Advances.

Bank Islam Malaysia Bhd Year 2002				Bahrain Islamic Bank Year 2002		
Mode of Financing	Malay Ringgit ('000)	% of Total Financing	% of Total Assets	Bahraini Dinars	% of Total Financing	% of Total Assets
Murābahah	1,515,033	24.66	12.49	138,680,913	84.16	66.12
Muḍārabah	40,306	.66	33	15,381,327	9.33	7.33
Mushārakah	216,934	3.53	1.79	3,561,599	2.16	1.70
Ijārah	111,064	1.81	.92	5,536,009	3.36	2.64
Qarḍ al-Ḥassan	497,216	8.09	4.10	125,000	0.08	.06
Ijārah bi Tamlīk	176,110	2.87	1.45	1,500,000	.91	.72
Bay` bi Thaman al-Ājil	3,475,374	56.56	28.65			
Total Financing	6,144,323	100	50.65	164,784,448	100	78.57
Total Assets	12,130,915			209,739,629		

Earlier in this paper, we established that *mudarabah* (trust financing) and *musharakah* (equity financing) are the pillars or foundations of the Islamic banking system. When the breakdown of the total allocation presented in table 1 is examined, it appears that both of them play virtually no role in these two Islamic banks, as compared to other modes of financing. For the Bank Islam Malaysia (Berhad), *mudarabah* accounts for only .66% of total financing; for the Bahrain Islamic Bank, it constitutes 9.33% of total financing. On average, *mudarabah* in these two Islamic banks is only 5%.

The other distinguishing Islamic financing instrument is the *musharakah* contract. In these two Islamic banks, as the data show, this financing mode is also insignificant: It is 3.53% (Malaysia) and 2.16% (Bahrain), respectively. On average, it constitutes only 2.85% of total Islamic financing. Even though *musharakah* appears to be very significant in principle, in practice it constitutes an insignificant proportion of Islamic financing in these two banks. Adding together the two bank's average *mudarabah* and *musharakah* financing, the total is only 3.92% of total financing. Thus, the two most notable Islamic products are seen, in practice, to constitute less than 4% of their total Islamic financing instruments.

With regards to *murabahah* (debt-like financing contracts), the data in table 1 show that such financing in Malaysia and Bahrain is 24.16% and 84.16%, respectively. On average, *murabahah* financing is 54.41% of total finance and advances. It should be noted that if the figures for *murabahah* and *bay` bi al-thaman al-ajil* are added together for the Bank Islam Malaysia (Berhad), the percent of total financing is 81.2%. This percentage compares favorably with that listed under *murabahah* for the Bahrain Islamic Bank (84.16%). No amount is shown under *bay` bi al-thaman al-ajil* for the Bahrain Islamic Bank. Aggregating the figures for these two types of financing is understandable, since their characteristics are quite similar. The average of total financing of these two Islamic banks under *murabahah* and *bay` bi al-thaman al-ajil* is 82.68%. From the point of view of some critics, *murabahah* is not a pure Islamic product; Nevertheless, the data show this mode of financing is dominant in the Islamic banks of Malaysia and Bahrain.

Qard al-hassan (benevolence/philanthropic) financing is another cornerstone of Islamic finance, for helping the poor and needy is a fundamental Islamic teaching. The extent of participation in this mode of financing was considered and found to be 8.09% in Malaysia and only 0.08% in Bahrain. This difference is probably due to the larger proportion of needy

people in Malaysia and the increased availability of governmental assistance for the needy in Bahrain. The average *qard al-hassan* financing by the Bank Islam Malaysia (Berhad) and the Bahrain Islamic Bank is only 4.09% of the total finance and advances.

The data on *ijarah* (general lease financing) show that the average *ijarah* financing of the two Islamic banks under discussion is 2.59% of their total finance and advances. With regard to the new Islamic financing instrument of *istisna`* (progressive payment), their balance sheets indicate no allocation. This suggests that they have not yet participated in this mode of financing. Given this, we can say that this new instrument appears to exist in theory but not yet in practice.

Zakat, a compulsory religious tax, is one of the five pillars of Islam that both individuals and businesses are required to observe. Therefore, Islamic banks are obligated to pay it as an integral part of Islamic finance. An examination of these two Islamic banks' income statements reveals that the Bank Islam Malaysia (Berhad) and the Bahrain Islamic Bank pay a zakat of RM 1,125,000 (6.13% of the total profit) and BD 1,341,555 (1.69% of the total profit), respectively, from their operating profits. It should be noted that both of these banks operate under the conventional business laws of their respective countries and thus pay this religious tax in addition to the conventional income tax.

In theory, *mudarabah* and *musharakah* constitute the foundation of the Islamic financial system. Nevertheless, the data presented here seem to indicate that they are utilized far less than other forms of Islamic financing, such as *murabahah*. Some possible explanations as to why these instruments are not utilized to a greater extent are discussed below.

Agency Problem

When a business is run by professional managers, as opposed to the owner or supplier of capital (debtholder or shareholder), a conflict of interest may arise. A manager is the business owner's agent. As the utility increases, managers will seek to maximize their own utility instead of maximizing the wealth or utility of the shareholders or the business owners. They have an incentive to increase their own salaries, fringe benefits, and other perks, all of which represent a conflict of interest that may lead them to place personal interest ahead of such corporate goals as maximizing the shareholders' profit margin.[31] This conflict is the most common problem in all businesses or corporations managed by agents rather than the shareholders or debthold-

ers themselves.[32] Given its prevalence, it is important to see how it applies to *mudarabah* and *musharakah*.

THE AGENCY PROBLEM IN *MUSHARAKAH* FINANCING. Earlier in this paper, *musharakah* was described as essentially a joint venture profit-sharing business of two or more parties in which the Islamic bank is an important partner or shareholder. Under *musharakah*, the bank relies on the other partner(s) to manage the business and make the day-to-day decisions. Even though the bank could monitor the management of the business by hiring external auditors and consultants, such measures would incur additional costs. Therefore, the bank must rely on professional managers or other partners to manage the businesses, even though these managers may have an incentive to maximize their own utility at the business owner's expense.

THE AGENCY PROBLEM IN MUDARABAH FINANCING. As Bacha states: "Mudarabah financing is really a hybrid. It is neither equity nor debt, because it has important features of both."[33] This type of financing has elements of equity financing, since the Islamic bank receives no fixed annual return. In fact, such a return from the business is similar to a dividend, which the business pays only if it earns a profit.

On the other hand, *mudarabah* has elements of conventional debt financing, because in the event of dissolution, the bank has a "fixed" claim on the venture equal to the initial capital provided, plus its share of any profits. Under *mudarabah*, the Islamic bank does not participate directly in management decisions. Rather, it relies completely on the business venture's trustee or entrepreneur. This trustee is clearly an agent of the Islamic bank and, therefore, is inherently subject to the agency conflict of interest.

Thus, under both *musharakah* and *mudarabah*, the Islamic bank experiences the agency problem with its associated costs. Islamic banks operate primarily in developing countries, where there is a high degree of financial market imperfection and a prevailing presence of inefficiency and corruption.[34]

The agency problem becomes more acute when banks have little access to dependable accounting information, due to a lack of standardized financial reporting requirements and procedures. The difficulties presented by this agency problem, together with the lack of verifiable financial data, complicate the profit-sharing characteristics of these forms of Islamic financing and actually encourage debt financing (e.g., *murabahah* and *ijarah*) over equity financing (e.g., *musharakah* and *mudarabah*).[35]

To some extent, the agency problem in *musharakah* and *mudarabah* can be reduced by carefully specifying the sharing of profit and performance bonuses between the entrepreneur and the bank. Also, in the case of *musharakah*, the bank participates in the election of the company's board and officers, a factor that should further reduce the agency problem.

Ambiguity in assets ownership. In *mudarabah* and *musharakah*, some ambiguity exists concerning the title to assets in case of default or dissolution of the business. Under *murabahah* and *ijarah*, there is no such ambiguity. In these debt-type contracts, title to the assets clearly remains with the bank until all payments have been made. Under a PLS contract, however, banks have no direct claim on the financed assets. As a result, it is rational for banks to opt for *murabahah* and *ijarah* contracts instead of *mudarabah* and *musharakah* contracts. In order to partially offset the increased risk of *musharakah* and *mudarabah* contracts, the business assets could be registered under the joint or co-ownership concept provided by a partnership or corporation arrangement.

It should be noted here that a western debt contract contains a considerable amount of ambiguity over just who controls the assets in the case of default. In western countries, default triggers bankruptcy proceedings, during which the entrepreneurs and the managers may continue to control the assets of the business. In contrast, there is no such ambiguity in the case of *murabahah* and *ijarah* contracts: The bank may seize the assets immediately.

Contract Maturity. Contrary to *mudarabah* and *musharakah*, *murabahah* financing constitutes a shorter term, lower risk investment for the bank. This form of financing involves buying goods at a low price and selling them immediately at a higher price. Such contracts require a specific payment schedule with known maturities. In contrast, the equity nature of *mudarabah* and *musharakah* contracts results in longer term, more uncertain maturities for these investments. These differing risk characteristics may bias the Islamic bank against *mudarabah* and *musharakah* financing. Primary data collected by Samad and Hassan[36] from the Malaysian Islamic Bank (Berhad) support this finding.

Privacy and Confidentiality. Entrepreneurs are, in general, independent, free-spirited people who jealously guard their proprietary information. Since joint management and supervision are important characteristics of *musharakah* financing, entrepreneurs may not view such requirements pos-

itively. Nevertheless, both *mudarabah* and *musharakah* require that the bank be given detailed knowledge of how the businesses they finance operate and be allowed to participate in all management decisions. This situation is likely to cause concern among those entrepreneurs who prefer to keep the details of their business operations private. Information on operating procedures and the degree of profitability is not usually shared willingly by entrepreneurs, who are concerned about competitors entering the marketplace. Such concerns may well decrease the demand for *mudarabah* and *musharakah* financing.

BIASED BANK PERSONNEL. Another possible impediment to a more rapid growth of *mudarabah* and *musharakah* may lie with the Islamic bank managers themselves. Islamic banks are currently managed by people who have been educated and trained in the conventional banking system. Thus, more time may be required for the unique characteristics of Islamic financial instruments to be completely accepted and understood by both bank personnel and customers. A similar observation is found in the study by Maniam, Bexley, and James.[37]

INVESTMENT CONSTRAINTS. As noted earlier, the Shari`ah restricts the type of businesses for which Islamic banks can provide financing. For example, they are not permitted to participate in certain prohibited investments or joint venture projects considered to be detrimental to the individual, society, or the environment. As a result, the scope of *mudarabah* and *musharakah* for Islamic banks is somewhat more limited than it is for conventional banks.

A LONG RECORD OF ESTABLISHED RELATIONS. Even though Muslims throughout the world could be expected to prefer to deal with an Islamic bank for purely religious reasons, the fact is that prior to the 1970s, when no Islamic banks were available, they dealt with conventional banks. Thus, banking relationships have already been established and, except for that segment of the banking community that is so religious that its members could be expected to transfer all of their banking transactions to the first available Islamic bank, others who would prefer the Islamic bank (if all else were equal) may base such decisions more on the relative economic advantage to them as consumers.

Therefore, it would seem incumbent upon Islamic banks to price their instruments in a way that the customers' net position is as current and com-

petitive as it is in the conventional banks. When the net economic consequences of being a customer of an Islamic bank are substantially the same as those associated with conventional banks, it could be expected that the religious preference of the majority of banking customers would attract them to Islamic banks and their Islamic financing instruments.

Competition from Conventional Banks. Islamic banks compete with conventional banks in both the deposit and credit markets. Some conventional banks, such as the Bank Bumiputra Malaysia Berhad, have introduced Islamic deposit instruments, thereby increasing the competition for funds. As a result of this increased competition, Islamic banks are finding it difficult to attract significant funds in the form of *mudarabah* deposits, a factor that further limits the growth of *mudarabah* and *musharakah* financing. Available data on the Bank Islam Malaysia (Berhad) reveal that of the total customer deposits of RM 11,056,355, the amount of *mudarabah* deposits was only RM 250,992 – a mere 2.27% of total deposits.

Conclusion

The above examination of the balance sheets, finance and advances, and income statements of two Islamic banks in Malaysia and Bahrain discloses that Islamic banks follow the Shari`ah's injunction to pay zakat and finance economic activities through Islamic contracts. Among these financial contracts, *mudarabah*, *musharakah*, *qard al-hassan*, and *istisna`* are the most distinguishing products in the theory of Islamic finance. However, the data indicate that for the two Islamic banks studied here, *mudarabah*, *musharakah*, and *qard al-hassan* financing are the least significant financial instruments. The average level of *mudarabah* financing engaged in by these two Islamic banks is only 5%, and for *musharakah* it is less than 3%, making the combined average less than 4% of total finance and advances. The average financing under the *qard al-hassan* (benevolence) mode is about 4%. *Istisna`* (progressive) is not yet used by these two Islamic banks.

Mark-up products, such as *murabahah* and *ijarah*, appear to be the most popular, for they dominate all other modes of Islamic financing. The average *murabahah* financing for these two Islamic banks is over 54%. When *bay` bi al-thaman al-ajil* and *murabahah* are considered together, the average financing of these two Islamic banks is 82.68%. These figures are significantly higher than the combined *mudarabah*, *musharakah*, and *qard al-hassan* financing (less than 12%). Further research should be conducted

to investigate the extent to which *mudarabah* and *musharakah* are utilized in other Islamic countries.

It is understandable that, during the initial development of the Islamic banking system, *musharakah* and *mudarabah* financing should be de-emphasized due to the increased risk associated with them. Nevertheless, we can expect that these Islamic financial instruments will increase in importance as the Islamic banking system continues to mature.

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